No. 10-662

Supreme Court, U.S.
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In The Supreme Court of the United States

ASWORTH, LLC (f/k/a Asworth Corporation); HTF, LLC (f/k/a HT-Forum, Inc.); and D AVIATION SERVICES, LLC (f/k/a D Aviation Services, Inc.),

Petitioners,

v.

DEPARTMENT OF REVENUE, FINANCE AND ADMINISTRATION CABINET, COMMONWEALTH OF KENTUCKY (f/k/a Revenue Cabinet, Commonwealth of Kentucky),

Respondent.

On Petition For A Writ Of Certiorari To The Kentucky Court Of Appeals

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether a State violates the Commerce Clause of the U.S. Constitution by enacting a taxing statute on a partner's share of Kentucky distributive share income from a partnership doing business both within and without Kentucky and deriving income from the partnership's activities in Kentucky when the statute has a doing business nexus standard rather than a physical presence nexus standard?

2. Whether a State violates the Due Process Clause of the U.S. Constitution by passing legislation that changes the calculation of when interest may begin to accrue on a tax refund claim, and such change applies "effective for refunds issued after April 24, 2008"?

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COUNTERSTATEMENT OF THE CASE

A. Physical Presence And *Quill*.

Contrary to Petitioners' assertion, there is no conflict warranting review by this Court, nor is it of pressing significance to American business. As Petitioners themselves admit, 35 states have passed legislation holding that physical presence is not required in order to impose tax outside the context of sales and use taxes. Further, while Petitioners attempt to manufacture a conflict, none exists. Of the three states that Petitioners point to as ruling that *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) extends to taxes outside of Kentucky, one decision specifically did not rule on this issue and was later called into question by the same court in a later case, the tax in another decision was subsequently eliminated by that State's legislature and replaced by another tax that did not require physical presence, and the third is easily distinguishable based upon the unique facts in that case. Other cases cited by Petitioners never addressed the Commerce Clause, or are merely administrative decisions or advisory opinions, rather than a holding by the State court of last resort. One of the cases relied upon by Petitioners is on appeal and not final. As a result, there is simply no conflict with respect to the Commerce Clause. Similarly, there is no conflict with *Quill* itself, which expressly declined to extend the physical presence standard beyond sales and use taxes.

Finally, the parade of horribles that will purportedly result if the Court does not take this case is simply speculative at best. The statute in dispute was limited to distributive share income from pass-through entities, and in no way extended to all taxpayers or to dividend income. In fact, despite Petitioners' claims to the contrary, American businesses have continued to operate, even in an environment where the majority of states have limited the physical presence standard to sales and use taxes. As the Court noted in *Quill*, resolution of this issue is best left to Congress.

B. Clarification Of House Bills 704 And 216 And Some Historical Context.

Petitioners briefly discuss how 2008 Ky. Acts, ch. 132, §8 ("House Bill 704") and H.B. 216, 2009 Gen. Assem., Reg. Sess. (Ky. 2009) ("House Bill 216," and collectively with House Bill 704, the "Bills"),[1] work mechanically in the Petition, but there are some misstatements that need clarification. Pet. 15, fn. 7. Some historical context is also appropriate in understanding how interest rates have applied to refund claims. When Kentucky first enacted a refund statute, back in 1938, interest was only authorized on overpayments resulting from error of Revenue or its agents. 1938 Ky. Acts, ch. 4, §6. In 1970, this statute

[1] House Bill 216 repealed and reenacted House Bill 704 in response to a potential procedural issue.

was amended to limit the authorization of the accrual of interest to overpayments resulting from a clerical error of Revenue or its agents. 1970 Ky. Acts, ch. 216, §2. In 1976, the law was again changed to increase the applicable interest rate on such refund claims from six percent to eight percent. 1976 Ky. Acts, ch. 155, §1. It was not until 1990 that this statute was amended to expand the authorization of the accrual of interest to refund claims other than constitutional or ad valorem taxes. 1990 Ky. Acts, ch. 423, §7. Notably, interest has never been allowed to accrue on refund claims resulting from constitutional claims or ad valorem taxes. *City of Somerset v. Bell*, 156 S.W.3d 321, 330 (Ky. App. 2005); KRS 134.590. The Constitution simply does not mandate interest on refund payments.

In 1982, KRS 131.183 was enacted to provide that the interest rate on assessments assessed on or after July 1, 1982, shall be 16%, and that the interest rate on certain overpayments would be at a rate equal to 75% of the interest rate on assessments. 1982 Ky. Acts, ch. 452, §3. In 1990, this statute was amended to provide that the interest rate on assessments and overpayments would be the same rate. 1990 Ky. Acts, ch. 423, §5. Notably, the federal government has established different interest rates for underpayments and overpayments since 1987.[2] In

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[2] Tax Reform Act of 1986, Pub. L. No. 99-514, §1511(a), 100 Stat. 2085, 2744 (1986). Originally, the federal government only charged interest on underpayments of tax; only in 1921 was the

(Continued on following page)

1999, the rates were equalized except for corporate taxpayers, who have a difference of one percent and, in some cases, four and one-half percent, between the interest rate for underpayments and overpayments. This is consistent with financial markets and other institutions, where the interest rate paid on savings accounts, for example, is not the same as the interest rate charged on loans. Without such a difference, one of the interest rates is out of synch with the general economy, encouraging either a delay in (i) the payment of taxes, to take advantage of a higher market rate, or (ii) requesting a refund of taxes, to take advantage of the higher interest rate on overpayments.[3] The difference removes such incentive.

Petitioners' claim that such legislation was arbitrary and unfounded is baseless. Notably, as part of this legislation, a fiscal note was attached to House Bill 704, when it was amended to include the disputed provision, which discussed the fiscal impact of the bill and the millions in savings to Kentucky as a result of enacting this legislation. A copy of this fiscal note is reprinted in Respondent's Appendix ("Resp. App.") at 1. As Petitioners note, the Bills also

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law changed to provide for interest on overpayments of federal tax. Internal Revenue Act of 1921, Pub. L. No. 67-98, §1324, 42 Stat. 227, 316.

[3] Similarly, the legislative change with respect to what date interest begins to accrue on an overpayment, encourages the prompt filing of refund claims, and can potentially reduce the amount of interest due at a time when the Commonwealth is experiencing revenue shortfalls and significant budget cuts.

changed the interest rate on refunds from "prime rate" to "prime less 2%," but that provision was prospective only in nature, and therefore not an issue before this Court. Pet. 15, fn. 7.

While Petitioners allege that two Orders granting their refund claims, in whole or in part, were summarily affected by the Bills,[4] pursuant to the Kentucky Court of Appeals' decision, they are not entitled to any refund. Obviously, there can be no interest on a nonexistent refund. Significantly, Petitioners seek a grant of certiorari on whether the denial of the refund claim is unconstitutional. Even assuming *arguendo* that they could prevail on that issue, their refund claim would then be grounded in Ky. Rev. Stat. §134.590. Interest has never been allowed to accrue on refund claims arising pursuant to that statute. *City of Somerset*, 156 S.W.3d at 330. As a result, regardless of whether the Court grants certiorari on the first issue, the interest issue is moot.

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[4] Under Kentucky law, however, a refund is not due until the matter is "finally adjudged" by either the Kentucky Board of Tax Appeals or a Court. Ky. Rev. Stat. §134.580(2). Therefore, Petitioners were not entitled to a refund until there was a final order. The two Orders referred to by Petitioners were not final orders.

C. Clarification Of The Factual Background.

While the material facts were largely stipulated to, there are a few misrepresentations by Petitioners in their Factual Background that need clarification.

Petitioners assert that the parties stipulated that they had no intangible property in Kentucky; however, that is incorrect. A copy of the stipulations is reprinted in its entirety at Resp. App. 4. The parties only stipulated that "[n]one of the [Petitioners] had any property, real or tangible personal, owned or leased, located in Kentucky during the involved tax years." Resp. App. 6. Similarly, the parties stipulated that "[n]one of the [Petitioners] had any employees or payroll in Kentucky during the involved tax years." *Id.* This was because Ky. Rev. Stat. §141.040 applied only to corporations who had either payroll or owned or leased either real property or tangible personal property in Kentucky. Revenue has never asserted that Petitioners were subject to tax pursuant to that statute.

Instead, the issue was (i) whether Ky. Rev. Stat. §141.206 was an imposition statute, and (ii) if so, whether Petitioners were constitutionally subject to tax under that statute. Ky. Rev. Stat. §141.206(5) specifically provides that nonresident corporations, such as Petitioners, "are taxable on their proportionate share of income passed through the partnership . . . attributable to business done in Kentucky" if they are partners in a partnership "which does business

within and without Kentucky[.]" The Kentucky Court of Appeals held that Petitioners' distributive share income (over $50 million during the years in question), which was derived from Petitioners' ownership interests in partnerships that earned income by doing business both within and without Kentucky[5] established either substantial nexus with and/or a physical presence within Kentucky.

Finally, Petitioners also assert that their holdings in partnerships doing business in Kentucky, Conwood Company, LP ("Conwood") and Conwood Sales Co. LP ("Conwood Sales") were passive investments. The parties never stipulated to that fact either. In fact, during at least part of the tax years in question, the parties stipulated that one of the Petitioners, Asworth Corporation (n/k/a Asworth, LLC, "Asworth"), held a general partnership interest in both Conwood and Conwood Sales. Resp. App. 10-11. The parties also stipulated that "[t]he [Petitioners'] business is managing investments in various legal entities." *Id.* at 6.

REASONS FOR DENYING THE PETITION

With respect to the questions presented in the petition, Petitioners have pointed to no genuine

[5] This distributive share income was apportioned to Kentucky pursuant to the apportionment method provided in Ky. Rev. Stat. §141.206(5).

conflict with prior decisions of either this Court or with State courts of last resort. The cases cited in the Petition with respect to the Commerce Clause issue show not conflict, but rather, a growing uniformity among the States which is consistent with the plain language of the Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). As a result, a decision on the merits would appear to be of little help in resolving other cases.

With respect to the second issue, even if assuming *arguendo* a conflict existed, as an initial matter, resolution of this issue cannot provide relief to Petitioners. If they are not entitled to a refund, the issue of how interest should be calculated on a nonexistent refund is moot. Even if they are entitled to a refund because Ky. Rev. Stat. §141.206 violates the Commerce Clause because it has a doing business standard, rather than a physical presence standard, pursuant to Ky. Rev. Stat. §134.590, no interest accrues on a refund claim based upon a tax being held unconstitutional, so again, the issue of how interest should be calculated on that refund is moot.

Additionally, there is simply no conflict with respect to *United States v. Carlton*, 512 U.S. 26, 30 (1994) or other decisions by the Court, nor are there any conflicts with other States that cannot easily be reconciled as slightly different applications of a properly stated rule of law. For all of these reasons, the Petition should be denied.

I. Rather Than Creating A Conflict Among State Courts, The Decision Enlarges A Growing Consensus Of The States' Highest Courts Rejecting The Claim That The Commerce Clause Requires "Physical Presence" To Establish "Substantial Nexus."

In determining whether to grant certiorari, the Court requires that a conflict of decisions be a "real and embarrassing conflict of opinion and authority." *Rice v. Sioux City Cemetery*, 349 U.S. 70, 79 (1955) (quotations omitted). Here, no such conflict exists. Since *Quill* was decided in 1992, the overwhelming majority of state courts have held that physical presence is not required in order for a State to impose a fairly apportioned, non-discriminatory net income tax on corporations doing business in the taxing State. No State supreme court has held otherwise. While Petitioners do their best to manufacture a conflict, a closer reading of the cases involved show that, if anything, there is a growing consensus, rather than a split, and there is no "real and embarrassing conflict of opinion and authority" warranting the granting of certiorari.

In attempting to establish their claim that a conflict exists, Petitioners rely primarily on *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). While on its face, this case appears to represent a wooden application of the *Quill* physical presence test with no meaningful discussion or analysis of the

differences between the taxes in *J.C. Penney* and *Quill,* it actually declined to rule on this issue. *Id.* at 839 ("Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bella Hess* and *Quill* are not within the purview of this court to discern.") This conclusion was largely based on the fact that no evidence had been presented as to why the Commerce Clause should be different for franchise and excise taxes. *Id.* The *J.C. Penney* court also held that it was not its role to determine whether physical presence is required under the Commerce Clause. *Id.* at 842. As one court noted, " . . . because the court in *J.C. Penney* specifically declined to address the precise issue before this court [whether *Quill's* physical presence requirement applied to taxes other than sales and use], we find its holding to have little value to our determination of the instant case." *Bridges v. Geoffrey, Inc.*, 984 So.2d 115, (La. App. 2008), *writ denied,* 978 So.2d 370 (2008). Significantly, the continued validity of the *J.C. Penney* opinion has been called into doubt in a subsequent unpublished decision by that court. *See e.g., American Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002) (rejecting a reading of *J.C. Penney* that "would simply substitute 'physical presence' for 'nexus.'").[6] Another court, in

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[6] Although unpublished, *America Online* has been relied upon in a published decision of the Tennessee intermediate appellate court. *Arco Building Systems, Inc. v. Chumley*, 209 S.W.3d 63, 74 (Tenn. App. 2006).

analyzing the two cases, concluded there was " . . . considerable doubt on whether [the Tennessee Court] adopted 'a bright-line test of requiring an out-of-state company to have a 'physical presence' in [Tennessee] in order to have substantial nexus with it.'" *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 196 (N.C. App. 2004), *cert. denied*, 546 U.S. 821 (2005) (citation omitted).

Another case cited by Petitioners, *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), likewise does not create a conflict. In *Rylander*, Texas sought to tax an out-of-State corporation merely because it had a license to do business in Texas. *Id.* at 299. The court held that possession of a license to do business, without any other economic activity, did not satisfy the substantial nexus requirement of *Complete Auto Transit*.[7] In addition, as recognized by *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. App. 2005), *cert. denied*, 510 U.S. 992 (1993), the language from *Allied-Signal* relied upon by the *Rylander* court was taken from the Court's discussion concerning Due Process, not the Commerce Clause, and is preceded by a citation to the Due Process portion of the *Quill* opinion. *Geoffrey*, 132

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[7] Petitioners cited two other Texas decisions: *Midland Cent. Appraisal Dist. v. BP America Prod. Co.*, 282 S.W.3d 215, 224 (Tex. App. 2009) and *Peoples Gas, Light, and Coke Co. v. Harrison Cent. Appraisal Dist.*, 270 S.W.3d 208 (Tex. App. 2008), which do little to establish that a conflict exists. Both involved ad valorem tax on the ownership of oil that was in transit in interstate commerce in a common carrier pipeline.

P.3d at 638. As a result, there is no conflict with respect to the Commerce Clause.[8] Whether there is a conflict with respect to the Due Process Clause is not an issue raised in the Petition.

Similarly, *Guardian Indus. Corp. v. Dep't of Treasury*, 499 N.W.2d 349 (Mich. App. 1993), *app. denied sub nom.*, 512 N.W.2d 846 (Mich. 1994) does not create a conflict. In this case, the taxpayer's principal place of business was in Michigan. The *Guardian* court was faced with the rather unique question of whether "sales" in other States were subject to tax in those States, and therefore excluded from Michigan income. Specifically, the question was whether Guardian had a physical presence in those other States, and if so, whether the activities conducted on Guardian's behalf exceeded that of mere solicitation. If it did not, then Michigan's single business tax would apply to those sales. *Id.* at 358. Here, the taxpayers argued that their nexus in other States was sufficient for taxation by those States; Michigan argued that nexus was insufficient in those States; and the taxing authorities in the other States were not involved in the case. Finally, *Guardian* has little remaining force even in Michigan: the Michigan legislature has eliminated the tax at issue

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[8] Similarly, Petitioners assert that this decision conflicts with *Acme Royalty v. Dir. of Revenue*, 96 S.W.3d 72 (Mo. 2002); however the Commerce Clause was not an issue in that case, either. As a result, there can be no conflict with respect to the Commerce Clause.

in *Guardian* and enacted a new tax that does not require a physical presence. MCL 208.1200(1). As a result, this decision does not present a "real" conflict.

Petitioners cite various opinions on page 22 of their Petition as acknowledging an "ever-growing" split; however, that is simply not the case. In fact, the *MBNA* court merely acknowledged that the Supreme Court had left the question open regarding the applicability of *Quill* to income and franchise taxes, which is not the same as acknowledging an "ever-growing" split between the states. *Tax Com'r of State v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 231 (W.Va. 2006), *cert. denied*, 551 U.S. 1141 (2007). In Massachusetts, the *Geoffrey* decision merely references the following in its analysis:

> Contrast *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299, 301 (Tex. Ct. App. 2000) (concluding that franchise tax based solely on taxpayer's mere possession of license to do business in Texas was invalid, but not addressing whether royalty payments from licensing of intangibles were sufficient to satisfy substantial nexus).

Geoffrey, Inc. v. Com'r of Revenue, 899 N.E.2d 87, 93 (Mass. 2009), *cert. denied*, 129 S.Ct. 2853 (U.S. 2009). Similarly, the *Capital One* case cited in the Petition contrasts the *J.C. Penney* decision in a footnote, and also acknowledges that this decision was subsequently questioned by *America Online*. *Capital One Bank v. Com'r of Revenue*, 899 N.E.2d 76, 85, fn. 16 (Mass. 2009), *cert. denied*, 129 S.Ct.

2827 (U.S. 2009).[9] Again, such references do not rise to the level of acknowledging an "ever-growing" split between the states. In fact, if anything, over time, the split has grown less, not more, as New Jersey has reversed itself on this issue,[10] Tennessee has questioned its earlier decision in *J.C. Penney*, and the Michigan legislature has eliminated the tax at issue in *Guardian* and enacted a new tax that does not require a physical presence. Page 18 of the Petition also notes that "[f]urther, at least 35 states have enacted legislation, regulations or policies specifically rejecting the physical presence test in income tax settings and stating that partnership interests alone create tax nexus. . . ." These statutory developments reduce the significance of the issue raised by Petitioners, provide consistency in the treatment of taxpayers, and further negate the need for review by this Court. Rather than a conflict existing between

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[9] In footnote 12 on page 22 of the Petition, while it is true that *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), *cert. denied*, 528 U.S. 965 (1999) noted that *Quill* was not limited to sales and use tax related disputes, that comment was in the context of *Quill's* Due Process analysis, not the Commerce Clause.

[10] Part of the split recognized by the court in *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004), *cert. denied*, 546 U.S. 821 (2005), was the New Jersey Tax Court's decision in *Lanco* that the physical presence requirement applied; however, that Tax Court decision was ultimately reversed, with the Supreme Court of New Jersey holding in *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007), that the physical presence requirement did not extend to income tax.

the States on this issue, there is increasing uniformity and consensus.

With respect to Commerce Clause decisions involving pass-through entities, Petitioners attempt to rely on *BIS LP, Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 88 (N.J. Tax 2009), *appeal docketed,* No. A1172-09 (N.J. Super. Ct. App. Div. Nov. 9, 2009);[11] however, that decision is a Tax Court decision, not a decision of the State's court of last resort, and critically, that decision is not final as it is on appeal to the New Jersey Superior Court. Similarly, several other cases cited in footnote 10 on page 18 of the Petition are administrative decisions and advisory opinions, not decisions of a State court of last resort. Supreme Court Rule 10 is clear that in considering whether to grant certiorari based on an alleged conflict, the conflict must be real and between state courts of last resort.

Petitioners cite another case involving pass-through entities in an attempt to establish a conflict, *Lanzi v. Alabama Dep't of Revenue*, 968 So.2d 18 (Ala. App. 2006), but even the plain language of the Petition shows that no conflict can exist with respect to the Commerce Clause, as the "Commerce Clause argument [was] not reached by the court." Pet. 18, fn. 10. The *Lanzi* court decided the case on Due Process

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[11] Moreover, the issue in *BIS* was whether the corporate partner was unitary with the partnership, not whether *Quill* applied, which is not an issue in this case.

grounds, however, Due Process is not an issue raised in the Petition. More importantly, Alabama has since moved away from the *Lanzi* decision. As held by the same court in a subsequent case, *Prince v. State Dep't of Revenue*, 2010 WL 1837773 (Ala. App. 2010) (not yet released for publication):

> We agree with Prince that the facts in *Lanzi* are not easily distinguishable from the facts in the present case with regard to due-process analysis. However, because *Lanzi* is a plurality opinion, it does not constitute binding authority. *See Waddell v. Waddell*, 904 So.2d 1275, 1285 (Ala. Civ. App. 2004). To the extent that the plurality opinion in *Lanzi* suggests that the imposition of a tax on the income Prince derived from the sale of Zebra.net's assets violates the Due Process Clause, we reject that view as inconsistent with our understanding of the Due Process Clause as requiring only "'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" *Allied-Signal*, 504 U.S. at 777.

Id. at *10. Ultimately, the *Prince* court held that a nonresident shareholder in a resident S corporation was subject to income tax based on income received through the sale of the resident corporation's Alabama assets, even though the nonresident shareholder did not engage in the operation or management of the S corporation. *Id.* at *9, 10.

Finally, Appendix J and K of the Petition fail to bear out Petitioners' assertion that a conflict exists.

With respect to the three states where courts have purportedly held that *Quill* applies to non-sales tax cases, none of these decisions were by their State's highest court and all are at least 10 years old. Further, *Rylander* was based on the Due Process Clause, rather than the Commerce Clause, *J.C. Penney* specifically held it was not deciding this issue and it has been subsequently called into question, and *Guardian* is no longer of effect, as the legislature eliminated the tax at issue and enacted a new tax that does not require a physical presence. The Appendix also lists other states as "likely to rule" in a certain way, but conflict warranting certiorari is to be real, not speculative. The Appendix also mysteriously lists New Jersey as "likely to apply *Quill* only to sales tax cases" when the New Jersey Supreme Court has expressly ruled on this issue; there is no "likely to apply" about it. *Lanco, Inc. v. Dir. Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007) ("We believe that the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes."). There simply is no "ever-growing conflict," let alone the "real and embarrassing" conflict necessary to warrant the granting of certiorari. If anything, there is growing consensus, both by recent decisions and State legislatures, on this issue. As a result, the Petition should be denied.

II. The Decision Is Consistent With *Quill*, Which Explicitly Holds That The Court's Precedents Do Not Establish A Physical Presence Requirement Beyond Sales And Use Taxes.

Although Petitioners assert otherwise, no precedent of this Court imposes a "physical presence" requirement for state franchise or income taxes as a precondition for "substantial nexus" under the Commerce Clause. Such a requirement exists only when collection of sales and use taxes is at issue. The test set forth in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), does not require a physical presence standard and should not now be altered to impose such a requirement for the income tax at issue here.

The Court in *Quill* re-examined the physical presence requirement set forth in *National Bellas Hess v. Department of Revenue* with respect to sales and use tax. In this examination, the Court noted that formal requirements such as physical presence had, in the interim, more generally been rejected in the Court's Commerce Clause cases, culminating in *Complete Auto. Quill Corp. v. North Dakota*, 504 U.S. 298, 309-11 (1992). The Court concluded however, that there was no sufficient reason to overturn the *Bella Hess* requirement in the sales and use tax area, citing *stare decisis* and Congress's own ability to change the result reached in that decision. *Id.* at 314-18.

Income tax is simply outside the scope of the precedents of this Court in *Bella Hess* and *Quill*. *Quill* itself specifically notes that such a requirement has not been imposed outside the sales and use tax context. Thus, not only is there no language in *Quill* supporting the extension of a physical presence requirement to any tax other than sales and use taxes, but the Court specifically states that in reviewing "other types of taxes [it had not] articulated the same physical-presence requirement." *Quill*, 504 U.S. at 314; *see also id.* at 317 ("in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line"). Simply put, there is no need to look beyond the plain language in *Quill* to disprove Petitioners' assertion that the Kentucky decision will "obliterate" the physical presence test set forth in *Quill*. Since *Quill* was decided 18 years ago, the Court has not expanded the physical presence requirement to any tax other than a use tax.

Significantly, the Court in *Quill* not only relied on *stare decisis* tied specifically to the sales and use tax setting, but also acknowledged that, but for *Bellas Hess*, "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," thus confirming that, contrary to Petitioners' assertion, the *Complete Auto* standard does not generally contain such a physical presence requirement. *Quill*, 504 U.S. at 311; *see id.* at 314 (Commerce Clause law generally "now favors more flexible balancing analyses"). Justice Scalia,

whose concurring opinion was joined by Justices Kennedy and Thomas, relied even more heavily on *stare decisis* in *Quill* (*id.* at 320):

> I also agree that the Commerce Clause holding of *Bellas Hess* should not be overruled. Unlike the Court, however, I would not revisit the merits of that holding, but would adhere to it on the basis of *stare decisis*. *American Trucking Assns., Inc. v. Smith,* 496 U.S. 167, 204 (1990) (SCALIA, J., concurring in judgment). Congress has the final say over regulation of interstate commerce and it can change the rule of *Bellas Hess* simply by saying so.

As New York's highest court described the result: "the *Quill* decision cannot be substantively construed as other than a somewhat begrudging retention of the *Bellas Hess* physical presence requirement" for imposition of a sales tax collection obligation. *Orvis Co., Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954, 960 (N.Y.), *cert. denied sub nom.*, 516 U.S. 989 (1995).

Petitioners incorrectly argue that "substantial nexus" can *only* be established through a physical presence standard. However, this assertion is rebutted by the plain language in *Quill*. Such a result also conflicts with the substantive analysis required by *Complete Auto*, which generally requires that interstate commerce pay its own way. *Complete Auto*, at 288-89, fn. 15. Petitioners also assert that the Kentucky Court of Appeals incorrectly juxtaposed the Commerce Clause and Due Process standards. Again,

this is not the case. The fourth prong of the *Complete Auto* test is that the tax must be "fairly related to services provided by the state." *Id.* at 287 (1977). The decision is fully consistent with *Complete Auto* and does not warrant further review by this Court. Significantly, Petitioners misstate the facts when they claim that they "have absolutely *no* physical presence in Kentucky, as stipulated to by Respondent – no real, tangible or intangible property, no office and no employees located in Kentucky." Pet. 27. What Revenue stipulated to was that (i) Petitioners did not have payroll in Kentucky during the relevant tax years, and (ii) Petitioners did not own or lease either real property or tangible personal property in Kentucky during the relevant tax years. Resp. App. 6. Throughout this case, the Revenue has consistently stated that Petitioners were not subject to corporation income tax pursuant to KRS 141.040 (which required that Petitioners either have payroll in Kentucky, or own or lease either real property or tangible personal property in Kentucky before tax could be imposed under that statute). Revenue has also consistently argued, and the Kentucky Court of Appeals agreed, that Petitioners were subject to tax on their distributive share income from partnerships doing business both within and without Kentucky pursuant to KRS 141.206. The statement that Revenue stipulated that Petitioners had no intangible property in Kentucky is simply untrue.

It is also a stretch to claim that under the Kentucky Court of Appeals' reasoning, *all* companies will

now be subject to state taxation as long as they receive income from an in-state company receiving "protection and benefits" from that state.[12] The statute in question only applied to shareholders or members of limited liability pass-through entities and S corporations with respect to their distributive share income; not shareholders of C corporations or any dividends they might receive. The Kentucky Court of Appeals held that Petitioners had either a substantial nexus with Kentucky or physical presence in Kentucky because of its partnership activities, citing *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 79-82 (Ill. App. 2000) (Commerce Clause does not prohibit Illinois from assessing replacement tax on a limited partner which has no connection with Illinois other than investing in a partnership). In discussing *Quill*, the *Borden* court held that "[w]e conclude that the requirement of a physical presence does not apply to the present case and, even if it did, plaintiff has a physical presence in the form of the Operating Partnership." *Borden*, 726 N.E.2d at 80. In fact, Petitioners must now accept that they have no complaint that the Kentucky taxes at issue are anything but fairly apportioned, non-discriminatory, and fairly related to the services ("protections and benefits") it receives from Kentucky, as these issues are

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[12] Again, the parties stipulated that Petitioners were in the business of managing investments in other entities, and that one of the Petitioners held a general partnership interest for part of the tax years in question. Resp. App. 5, 8-9.

not part of the Petition. Issues regarding apportionment, discrimination and fairly related are separate and distinct from nexus.

With respect to the income taxes at issue here, Petitioners cannot legitimately claim any surprise or violation of settled or reasonable expectations in being subjected to taxation that is fairly apportioned, non-discriminatory, and fairly related to the services provided by Kentucky. In fact, Petitioners initially paid the taxes in question and only later filed refund claims. Moreover, the lack of a bright-line physical presence standard in the context of income tax is consistent with unitary cases, where a corporation with no physical presence in a state may be taxed by that state if that corporation is considered to be so closely intertwined with other related entities as to be treated under the legal fiction of being part of a single unitary group. *Barclays Bank PLC v. Franchise Bd. of Calif.*, 512 U.S. 298 (1994). In *Barclays*, the United Kingdom cited *Quill* in support of its argument that Barclays Group members operating exclusively outside the United States did not have sufficient contacts with California under the Commerce Clause. *Id.* at 312. The Court rejected this argument, stating there were "certain intangible 'flows of value' within the unitary group serve to link the various members together as if they were essentially a single entity." *Id.* While the companies themselves did not have an actual physical presence in California, the unitary relationship with companies who did have a

California presence was held to satisfy the Commerce Clause. *Id.*

Petitioners claim that failure to impose a physical presence requirement would create "unconscionable results"; however, this assertion is clearly incorrect for several reasons. First, Petitioners themselves initially paid the tax before later filing refund claims. Second, even the "physical presence" standard is not the bright line test that Professor Pomp asserts it to be. As Justice White pointed out in *Quill*, "reasonable minds surely can, and will, differ over what showing is required to make out a 'physical presence' adequate to justify imposing responsibilities for use tax collection." *Quill*, 504 U.S. at 330, 331 (concurring in part and dissenting in part). Third, interstate commerce has continued to flourish under modern Commerce Clause jurisprudence, even in the absence of an overarching "physical presence" requirement, and more importantly, even though " . . . at least 35 states have enacted legislation, regulations or policies specifically rejecting the physical presence test in income tax settings and stating that partnership interests alone create tax nexus. . . ." Pet. 18. Petitioners have pointed to no litigation or practical problems arising from these statutes, regulations and policies. Mere speculation does not establish clear proof that this case is of such "gravity and importance" as to warrant review by this Court. In fact, the lack of litigation resulting from these statutes and regulations tends to indicate that the legislation is workable and not unduly burdensome,

and certainly undermining any contrary contention by Petitioners. Even if this should change, Congress can readily intervene to protect the national economic interest, as it has done in other occasions. As this Court said in *Quill*, Congress has the power under the Commerce Clause to "evaluate the burdens that taxes impose on interstate commerce." *Quill*, 504 U.S. at 36. Whatever ruling this Court might make on the merits of the issue here, "Congress remains free to disagree with [the Court's] conclusions." *Id.*

Finally, under Petitioners' theory, a business owning and leasing to another company a store in Kentucky, and generating $100,000 of revenue from the lease, would have physical presence in Kentucky and be subject to taxation. However, companies such as Petitioners, receiving tens of millions of dollars of distributive share income from its partnerships which do business within and without Kentucky, would be immune from a fairly apportioned, non-discriminatory income tax on partners. Similarly, a company receiving millions of dollars in revenue from royalty payments from firms licensed to use its intangible property in Kentucky would also be immune.[13] Such a test would only measure how a taxpayer does business, not the substance or significance of the contacts between a taxpayer and the taxing State. This result would clearly conflict with

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[13] This point also is raised by Justice White in a separate opinion, concurring in part, and dissenting in part, from the majority. *Quill*, 504 U.S. at 327-29.

Complete Auto and its substantive analysis standard. The Petition should be denied.

III. The Decision Neither Eviscerates *Carlton* Nor Furthers A Split On The Constitutional Standards Governing Retroactive Tax Legislation.

A. This Issue Is Moot, As Petitioners Are Not, And Cannot Be, Entitled To Any Interest.

As an initial matter, unless this Court takes the physical presence issue up on certiorari, Petitioners are presently not entitled to any refund of tax, much less interest, and therefore, the issue regarding the retroactive calculation of statutory interest on a nonexistent refund is moot. Even if this Court takes the physical presence issue up on certiorari, and reverses the decision by holding that KRS 141.206 unconstitutionally had a doing business standard, rather than a physical presence standard, the applicable refund statute would be KRS 134.590, which applies to refunds of taxes held unconstitutional. Pursuant to that statute, Petitioners would not be entitled to *any* interest on their refund claim, and so again, this issue is moot. Even assuming *arguendo* that a conflict existed with respect to *Carlton*, resolution of this issue could not change the result below, since Petitioners still would not be entitled to interest. *Sommerville v. United States*, 376 U.S. 909 (1964) (certiorari denied where resolution of the conflict

could not change the result reached below). As the Court has previously stated:

> While this Court decides questions of public importance, it decides them in the context of meaningful litigation. Its function in resolving conflicts among the Court of Appeals is judicial, not simply administrative or managerial. Resolution here of the [issue in conflict among the circuits] can await a day when the issue is posed less abstractly.

The Monrosa v. Carbon Black Export, Inc., 359 U.S. 180, 184 (1959). The Petition should be denied.

B. The Court Has Previously Held That The Retroactive Denial Of Interest Does Not Violate Due Process Or Any Other Constitutional Provision.

The Court has held that the retroactive denial of interest does not violate Due Process or any other constitutional provision. *Morley v. Lake Shore & M.S. Ry. Co.*, 146 U.S. 162, 170, 171 (1892) (law reducing rate of interest upon judgments upheld even when retroactively applied to a judgment obtained prior to the law's enactment, because interest is in the nature of damages, and does not arise out of contract); *Missouri & Arkansas Lumber & Mining Co. v. Greenwood Dist. of Sebastian County*, 249 U.S. 170 (1919). Both of these decisions are still good law, and were not overruled by *Carlton*.

Kentucky has held " . . . that the rate of interest on judgments is a statutory rather than a contractual matter." *Ridge v. Ridge*, 572 S.W.2d 859, 861 (Ky. 1978). Moreover, "As a general rule, unless interest is expressly authorized by statute, it is not awardable against the sovereign." *Department of Revenue v. Jack Cole Co.*, 474 S.W.2d 70, 74 (Ky. 1971), citing *Coleman v. Reamer's Ex'r*, 237 Ky. 603, 36 S.W.2d 22 (1931) (denying interest as the statute authorized interest only when the refund was a result of a clerical error). *See also*, *City of Somerset*, 156 S.W.3d at 330. The Bills, which address how interest is to be calculated on a refund claim, do not violate either Due Process or prior holdings of the Court.

C. The Court Has Previously Upheld Retroactive Statutes That Make A Reasonable Change In The Remedy, And Did Not Require A "Modesty Requirement" As Part Of The Analysis.

The Court has previously noted that the constitutional impediments to retroactive legislation are now "modest." *Landgraf v. USI Film Products*, 511 U.S. 244, 272 (1994). Similarly, in *Bradley v. School Bd. Of Richmond*, 416 U.S. 696 (1974), while a case was pending before the Court of Appeals, Congress enacted a law which authorized federal courts to award a reasonable attorney's fee to prevailing parties in school desegregation cases. The Court held that the award of fees for services performed prior to the effective date of enactment was permissible, as "the

principle that a court is to apply the law in effect at the time it renders its decision, unless doing so would result in a manifest injustice or there is statutory direction or legislative history to the contrary." *Bradley*, 416 U.S., at 711. As the *Landgraf* court noted in discussing *Bradley*, attorney's fees are "collateral to the main cause of action" and "uniquely separable from the cause of action to be proved at trial." *Landgraf*, 511 U.S., at 278, quoting *White v. New Hampshire Dept. of Employment Security*, 455 U.S. 445, 451-52 (1982). The Court has also held that the *Ex Post Facto Clause*, does not limit "legislative control of remedies and modes of procedure which do not affect matters of substance." *Beazell v. Ohio*, 269 U.S. 167, 171 (1925). None of these cases imposed a "modesty" requirement as part of their analysis. Similarly, the issue of how much interest accrues on a refund claim is a remedial measure which is collateral to the main cause of action, namely, Petitioners' right to a refund.

Petitioners have no vested right in a refund claim, much less the interest accruing on a refund claim, nor is interest on a refund claim a contractual obligation. No new rights, duties or obligations are created by the Bills. The Bills neither deprived Petitioners of their right to a refund, assuming they ultimately prevailed on those claims, nor did it completely deprive them of interest. Instead, the Bills merely changed how interest was to be calculated on a refund claim pursuant to Ky. Rev. Stat. §134.580 from interest beginning to accrue after the later of

two (2) different events, to the later of five (5) different events, a procedural measure that did not affect any substantive rights. As a result, the Bills do not violate the Due Process Clause or prior holdings of the Court.

D. The Court Has Previously Upheld An Unlimited Period Of Retroactivity, Which Holdings Were Not Reversed By *Carlton*.

The Bills in question are remedial, rather than tax or economic legislation. However, even with respect to tax and economic statutes, the Court has previously upheld unlimited periods of retroactivity, concluding that in each case, the Due Process Clause was not violated. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976); *Millikin v. United States*, 283 U.S. 15 (1931). Notably, the Court in *Carlton* quoted both decisions in its discussion of the standard to be applied under the Due Process Clause applied to tax statutes or other retroactive economic legislation:

> Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .
>
> To be sure, . . . retroactive legislation does have to meet a burden not faced by legislation that has only future effects. . . . 'The retroactive aspects of legislation, as well as the

> prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former' . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose." *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.*, 467 U.S. 717, 729-730 (1984), quoting *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976).

Carlton, 512 U.S., at 30-31. In rejecting the taxpayer's claim regarding lack of notice, the Court held that " . . . in *Millikin v. United States*, the Court rejected a similar notice argument, declaring that a taxpayer 'should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation.' 283 U.S., at 23[.]" *Carlton*, 512 U.S., at 34.

Even if the amount of the tax, rather than the amount of interest accruing on a tax refund, had been involved, the Court in *Carlton* held that avoiding a "significant" loss of public revenues is a constitutionally legitimate purpose. *Id.* at 32. The fiscal note for House Bill 704 specifically noted the millions in savings to Kentucky that would result from changing how the interest on a refund claim is calculated. Resp. App. 1. *Carlton* also held, "[t]ax legislation is not a promise and a taxpayer has no vested right in the Internal Revenue Code." *Id.* at 33. Therefore, there are no substantive Due Process rights involved in this case.

Notably, *Carlton* did not reverse the holdings in either *Usery* or *Millikin*, even though both cases were quoted in its decision.[14] The decision is consistent with the holdings in *Usery* and *Millikin*, as the Bills were supported by a legitimate legislative purpose furthered by rational means.

E. *Carlton* Did Not Mandate A "Modesty Requirement" As A Prerequisite To Any Due Process Analysis.

Despite Petitioners' claims to the contrary, *Carlton* never imposed a "modesty" requirement as a prerequisite to any Due Process analysis. Instead, the Court in *Carlton* held that, "[b]ecause we conclude that retroactive application of the 1987 Amendment to Section 2057 is rationally related to a legitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause." *Id.* at 35. The "modesty" requirement is not contained in the ultimate holding, but instead, is discussed as a factor, but not the controlling factor, to be considered in determining whether the retroactive application is rationally related to a legitimate legislative purpose.

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[14] Notably, *Carlton* did specifically discuss several other cases, and held that "[t]o the extent their authority survives, they do not control here." *Carlton*, 512 U.S., at 34. Clearly, if *Carlton* intended to reverse or otherwise limit *Millikin* and *Usery*, it could have done so.

While it is true that Justice O'Connor, in a concurring opinion, implied that "modesty" was a due process guarantee, her separate opinion carried no other votes.

Justices Scalia and Thomas, in a separate concurring opinion, took the view that the timing of the legislation is not even relevant to the analysis, stating:

> . . . the critical event is the taxpayer's reliance on the incentive and the key timing issue is whether the change occurs after the reliance; that it occurs immediately after rather than long after renders it no less harsh.
>
> The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid. To pass constitutional muster the retroactive aspects of the statute need only be "rationally related to a legitimate legislative purpose." *Ante*, at 2024. Revenue raising is certainly a legitimate legislative purpose, *see* U.S. Const., Art. I, §8, cl. 1, and any law that retroactively adds a tax, removes a deduction or increases a rate rationally furthers that goal. I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process, *see TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 470-471, 113 S.Ct. 2711, 2726-2727, 125 L.Ed.2d 366 (1993) (SCALIA, J., concurring in judgment).

Carlton, 512 U.S., at 40 (Scalia & Thomas, JJ., concurring). Contrary to Petitioners' allegations, Justices Scalia and Thomas did not view this result to be a problem, but rather, a welcome result.

Further, Petitioners misrepresent the holding by the Kentucky Court of Appeals with respect to the "modesty requirement." The full text of the decision is as follows:

> The Corporations also contend that the four-year period of retroactivity in this case fails to meet the "modesty requirement" of retroactive tax legislation under *Carlton*. However, contrary to the Corporations' assertion, the holding in *Carlton* did not establish such a "modesty requirement;" rather, the majority simply noted with favor that "Congress acted properly and established only a modest period of retroactivity." *Id.* at 32, 114 S.Ct. at 2023. This suggests to us that the period of retroactivity is to be considered in determining whether the legislation rationally furthers a legitimate governmental purpose. Here the Bills retroactively applied to all outstanding refund claims for taxable years ending prior to the Bills' effective dates, and to all claims for those taxable years pending in any judicial or administrative forum. We hold that the retroactive period extending to outstanding claims as of the Bills' effective dates does not violate the due process clause.

Pet. App. 20a. Rather than ignoring the "modesty requirement," the Kentucky Court of Appeals applied

it in a manner consistent with *Carlton*, both as expressed by the majority and the concurring opinion by Justices Thomas and Scalia, which is that the test is whether the legislation rationally furthers a legitimate governmental purpose, and as part of that test, the period of retroactivity may be considered. The decision is consistent with *Carlton*.

F. There Is No Split Regarding *Carlton*, As The Decisions Can Be Easily Reconciled As Slightly Different Applications Based Upon The Individual Facts And Circumstances Of The Decisions.

Petitioners cite a variety of cases in an attempt to manufacture a conflict; however, the Petition fails to make any showing that the *Carlton* test has bemused the lower courts, or has led to decisions by different courts that cannot easily be reconciled as slightly different applications of a properly stated rule of law. This is not surprising, since the underlying test is whether the retroactive legislation is "rationally related to a legitimate legislative purpose," which by its very nature is highly dependent upon the individual facts and circumstances of a particular case, and is not a one size fits all analysis. Significantly, none of the cases cited by Petitioners involve facts similar to those in this case, namely the calculation of interest on a refund claim.

Petitioners also argue that a shorter "modesty" period should apply to "non-curative" legislation;

however, other than a blanket assertion that the Bills are "non-curative," Petitioners provide no support for this statement, and simply ignore the fiscal note associated with the Bills. Petitioners also cite the *Landgray* [sic] case; however, as previously discussed, *Landgraf* supports the conclusion of the Kentucky Court of Appeals that the Bills did not violate the Due Process Clause.

Finally, Petitioners' argument that a use-it-or-lose-it limitation exists on a legislature's constitutional power cannot be squared with *Carlton's* express holding that "a taxpayer has no vested right in the Internal Revenue Code" protected by the Due Process Clause, 512 U.S. at 33, or reconciled with the precedents upon which *Carlton* relied. *See, e.g., Millikin v. United States*, 283 U.S. 15 (1931) (sustaining statute increasing federal estate tax on gifts made in contemplation of death, applicable with an unlimited period of retroactivity to all gifts made prior to enactment); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976) (sustaining federal statute imposing liability on employers for black lung benefits, applicable with an unlimited period of retroactivity for all prior employees). Nor can it be squared with the unlimited retroactive effect of the Court's decisions.[15]

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[15] All the Court's decisions are "the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule." *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 97 (1993).

If the retroactive legislation serves a legitimate legislative purpose, it should not be invalidated simply because Congress, or a state legislature, did not act within a year. For all of these reasons, the Petition should be denied.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX A

COMMONWEALTH OF KENTUCKY
STATE FISCAL NOTE STATEMENT

GENERAL ASSEMBLY
2008 REGULAR SESSION

LEGISLATIVE RESEARCH COMMISSION
2008-2010 INTERIM

MEASURE

(X) 2008 BR No. 1721

(X) House **Bill No.** 568 HCS

( ) Resolution No. _____

( ) Amendment No. _____

SUBJECT/TITLE AN ACT relating to interest.

SPONSOR Rep. D. Pasley and H. Moberly Jr.

NOTE SUMMARY

Fiscal Analysis:

X Impact ___ No Impact ___ Indeterminable Impact

Level(s) of Impact

X State ___ Local ___ Federal

Budget Unit(s) Impact _____

Fund(s) Impact:

X General X Road ___ Federal

_____ Restricted Agency (Type)

_____ (Other)

FISCAL SUMMARY

Fiscal Estimates	2007-2008	2008-2009	2009-2010	Future Annual Rate of Change
Revenues (+/-)		+$2,000,000	+$2,000,000	
Expenditures (+/-)				
Net Effect		+$2,000,000	+$2,000,000	

MEASURE'S PURPOSE:

The bill prevents the accrual of interest on refund claims from beginning prior to the Department of Revenue receiving the refund claim.

PROVISION/MECHANICS:

The bill modifies the date from which interest begins to accrue on refunds issued by the Department of Revenue to the latest of:

- The due date of the return;
- The date the return was filed;
- The date the tax was paid;
- The last day prescribed by law for filing the return; or
- The date an amended return claiming a refund is filed.

FISCAL EXPLANATION:

The $2 million fiscal impact noted above represents the ongoing, operational savings to be realized by the Commonwealth.

The provisions of the bill apply retroactively to all outstanding refund claims for taxable years ending prior to the effective date of the Act and also apply to all claims for those taxable years pending in any judicial or administrative forum.

To the extent that the Commonwealth fails to prevail on issues pending litigation, additional savings will be realized to the extent that the date that interest begins to accrue has been set to a later date, in most circumstances, by this legislation.

DATA SOURCE(S) **OSBD**

NOTE NO. **115.1** **PREPARER** **Jennifer Hays**

REVIEW **LBH** **DATE** **2/26/08**

LRC 2008-1721-HB568-HCS

APPENDIX B

COMMONWEALTH OF KENTUCKY
KENTUCKY BOARD OF TAX APPEALS
FILE NOS. K00-R-31, K02-R-30, K02-R-31, K02-R-32

ASWORTH CORPORATION, HT-FORUM, INC. (N/K/A HTF, LLC) AND D AVIATION SERVICES, INC. (N/K/A D AVIATION SERVICES, LLC) — APPELLANTS

v.

STIPULATIONS

REVENUE CABINET (N/K/A FINANCE AND ADMINISTRATION CABINET, DEPARTMENT OF REVENUE), COMMONWEALTH OF KENTUCKY — APPELLEE

* * * * * * *

Come now the Appellants, Asworth Corporation, HT-Forum, Inc., now known as HTF, LLC, and D Aviation Services, Inc., now known as D Aviation Services, LLC (collectively hereinafter referred to as the "Appellants" or individually as ["Asworth"], ["HTF"], and ["D Aviation"], respectively), and the Appellee, Revenue Cabinet now known as Finance and Administration Cabinet, Department of Revenue, Commonwealth of Kentucky ("Revenue"), and hereby submit their Stipulations in this matter.

In accordance with KRS 13B.080 and 802 KAR 1:010, Section 3(5), and pursuant to the Board's Notice and Order of Pre-hearing Conference of March

25, 2005, the Appellants and Revenue agree to these Stipulations pursuant to the general terms of this Preamble.

(A) Any Stipulated Joint Appendix filed with the Board herein identifies all stipulated documents. Except as noted herein, each document is admissible in evidence for any relevant and material purpose.

(B) The truth and/or probative value of assertions contained in any document with any Stipulated Joint Appendix filed with the Board herein are not stipulated and may be corroborated or rebutted by either party unless specifically provided to the contrary. Each stipulated document in any Stipulated Joint Appendix, however, shall be considered true, genuine and authentic and a copy of any stipulated exhibit or document shall be treated as though it were the original of same under the Kentucky Rules of Evidence and KRS Chapter 13B.

1. Asworth is a Nevada corporation created under the laws of Nevada. Asworth maintains its principal place of business in Chicago, Illinois, and it has no commercial domicile in Kentucky. Asworth was formerly known as Dalfort Corporation, but changed its name to Asworth Corporation in or around 1995.

2. HTF was a corporation created under the laws of the State of Delaware, and its principal place of business is also in Chicago, Illinois. It converted to a limited liability company and changed its name to HTF, LLC, effective January 1, 2000.

3. D Aviation was a corporation created under the laws of the State of Delaware, originally under the name of Dalfort Aviation Services, Inc., and its principal place of business is also in Chicago, Illinois, This corporation changed its name to D Aviation on or about December 30, 1997. It later converted to a limited liability company and changed its name to D Aviation Services, LLC on January 1, 2000.

4. Revenue is an administrative agency of the Commonwealth of Kentucky authorized under Chapters 141 of the Kentucky Revised Statutes to enforce the provisions of the Kentucky corporation income tax laws.

5. The Appellants' business is managing investments in various legal entities.

6. None of the Appellants had any property, real or tangible personal, owned or leased, located in Kentucky during the involved tax years.

7. None of the Appellants had any employees or payroll in Kentucky during the involved tax years.

8. None of the Appellants are domiciled in Kentucky, nor have they ever been.

Tax Years 1993-1996

9. As of January 31, 1993, Asworth owned a 99% limited partnership in Conwood Company, LP ("Conwood"), a Delaware limited partnership. Conwood has its commercial domicile and principal

place of business in Memphis, Tennessee. Conwood began its business operations in the 1700's, and is a manufacturer of smokeless tobacco.

10. GP Corporation ("GP"), a corporation incorporated under the laws of the state of Delaware, owned a 1% general partnership interest in Conwood until 1996.

11. For the taxable periods ending January 31, 1993, January 31, 1994, January 31, 1995 and January 31, 1996, Asworth filed Kentucky corporation income tax returns [Forms 720] and paid Kentucky corporate income tax calculated by using the standard three-factor apportionment formula (property, payroll and receipts) under KRS 141.120 to apportion its multistate income to Kentucky, and included the property, payroll and receipts of both Asworth and Conwood.

12. Asworth also filed Kentucky corporation license tax returns and paid the Kentucky corporate license tax of KRS 136.070 using the same methodology it utilized for corporate income tax for the taxable periods ending January 31, 1993 through January 31, 1996.

13. Revenue conducted a corporation income and license tax examination ("audit") of Asworth for taxable years ending January 31, 1993 through January 31, 1996. At the end thereof, Revenue asserted that Asworth had an increased corporation income tax of $654,629, plus applicable interest and penalties, and a decreased corporate license tax

liability of $79,229 for taxable years ending January 31, 1993 through January 31, 1996.

14. During this audit, Revenue examined Asworth's ownership in the partnership(s) involved herein. In concluding that Asworth's partial ownership of Conwood constituted Asworth's only connection to Kentucky, Revenue also concluded that Asworth should not have included the receipts of Asworth and all of its affiliated entities' receipts in the calculation. Consequently, Revenue redetermined Asworth's receipts apportionment factor, and included only Conwood receipts in Kentucky [presented in the formula] over Conwood receipts everywhere in the calculation(s).

15. Revenue also determined that Asworth was not required to file a Kentucky corporation license tax return, as was stated in the Auditor's Narrative Report, "[b]ecause the taxpayer's only tie to the state of Kentucky is investments in partnerships. . . ." Agent's Narrative Report.

16. Based on this single-factor apportionment methodology, Revenue concluded that a corporation income tax deficiency existed, but also determined that Asworth had no corporation license tax liability because Asworth had no property or payroll in Kentucky. Revenue has since refunded the corporate license tax overpayment to Asworth.

17. Asworth chose not to protest the assessment, and after payment of the assessed taxes, it then filed amended returns requesting a refund of

$1,993,207, which amount represents the corporation income taxes paid with the original returns, as well as the increased amount of tax due to Revenue's audit assessment. Interest, penalties and fees in the amount of $410,804 were paid in addition to the tax amount set forth above. Thus, Asworth's refund claim for tax periods ending January 31, 1993 through January 31, 1996 totaled $2,404,011 including tax, interest, fees and penalties.

18. Asworth paid the audit-related assessed tax and interest on November 5, 1998, and paid the assessed penalties and fees on February 5, 1999. On November 11, 1998, Asworth filed a refund claim for the taxable year ending 1994 and, on January 15, 1999, filed a refund claim for the remainder of the taxable years under audit, contending that it had no nexus with Kentucky under KRS Chapter 141, and therefore was not subject to corporate income tax.

19. The parties are in agreement that Asworth's refund claims for tax years ending January 31, 1994 through January 31, 1996 were timely filed.

20. The parties are also in agreement that Asworth's refund claim for taxable year ending January 31, 1993 insofar as it pertains to the tax, interest, penalties, and fees paid on November 5, 1998, was timely.

21. Asworth requested a conference with Revenue pursuant to KRS 131.110 and the conference was held on April 27, 2000. Revenue denied all of Asworth's claims for refund on May 3, 2000, and

Asworth filed a timely Protest in response to Revenue's denial of the refund claim on June 15, 2000. Asworth filed a Supporting Statement on July 31, 2000.

22. On November 17, 2000, a second conference with Revenue was held. A Final Ruling was requested on that date pursuant to KRS 131.110. Asworth filed a second Supplemental Supporting Statement addressing certain constitutional issues on November 29, 2000.

23. Revenue subsequently issued a Final Ruling on November 29, 2000 upholding its denial of Asworth's corporation income tax refund claims.

24. Asworth filed a timely Petition of Appeal with the Kentucky Board of Tax Appeals on December 28, 2000.

25. Asworth exhausted all required administrative steps prior to filing this action.

Tax Years 1997-1999

26. Asworth's corporate structure changed in that from November 1, 1996 through April 30, 1997: (1) Asworth contributed 1% of its limited partnership interest in Conwood to D Aviation Services; (2) GP merged with Asworth and thus acquired GP's 1% interest; and (3) Asworth converted 51% of its limited partnership interest in Conwood into a general partnership interest. As a result of Asworth's above changes in corporate structure, Asworth's total

general partnership interest equaled 52% and Asworth's limited partnership interest equaled 47%.

27. Asworth thereafter contributed its 47% limited partnership interest in Conwood to HTF, and Conwood Sales Company LP ("Conwood Sales"), a Delaware limited partnership, with its commercial domicile and principal place of business in Memphis, Tennessee, was formed to conduct sales and marketing activities; in return for this contribution each partner of Conwood received an identical ownership interest in Conwood Sales.

28. Conwood and Conwood Sales are distinct legal entities and are independent from the Appellants.

29. On November 15, 1996, Asworth contributed 1% of its limited partnership interest in Conwood to D Aviation. Asworth contributed its limited partnership interests in Conwood and Conwood Sales to D Aviation on April 30, 1997, and D Aviation changed its tax year end to December 31, effective with the tax year ended December 31, 1997.

30. From May 1, 1997 through December 31, 1999 the corporate structure changed as follows: (1) Conwood LLC, Conwood-1 LLC and Conwood-2 LLC, all single member LLCs, were formed in 1997; (2) Asworth contributed a 5% general partnership interest in Conwood and a 5% general partnership interest in Conwood Sales to Conwood LLC; (3) Asworth converted the remaining 47% general partnership interest in Conwood to a limited partnership

interest and then contributed that to HTF; (4) Asworth converted the remaining 47% general partnership interest in Conwood Sales to a limited partnership interest and then contributed it to HTF; and (5) Asworth and HTF changed their tax year ends to December 31, effective with the tax year ended December 31, 1997.

31. For the years ending January 31, 1997, December 31, 1997, December 31, 1998 and December 31, 1999, Asworth filed Kentucky corporation income tax returns and paid Kentucky corporation income tax.

32. For the years ending January 31, 1997, December 31, 1997, December 31, 1998 and December 31, 1999, HTF filed Kentucky corporation income tax returns and paid Kentucky corporation income tax.

33. For the years ending January 31, 1997, December 31, 1997, December 31, 1998 and December 31, 1999, D Aviation filed Kentucky corporation income tax returns and paid Kentucky corporation income tax.

34. On or about January 30, 2001, Asworth believes it timely filed amended returns/refund claims with Revenue, contending that it did not have any tax liability in Kentucky and sought tax refunds and statutory interest for all such tax paid for the taxable years ending January 31, 1997 and December 31, 1997 ("1997 Refund Claims").

35. Revenue has agreed that Asworth's counsel's letter of March 26, 2001 constituted a timely refund claim for the 1997 Refund Claims.

36. The 1997 Refund Claims have not been approved or denied to date by Revenue, and are not before this Board for review.

37. On August 16, 2002, Asworth timely re-filed an amended return/refund claim with Revenue, contending that it did not have any tax liability to Kentucky, and seeking refunds and statutory interest for all such tax paid for the taxable year ending December 31, 1997.

38. The parties agree that the 1997 Refund Claims will be held in abeyance at the Department pending a final and unappealable decision by the Board or any Court. The parties further agree to be found by a final and unappealable Board or Court decision, such that if the Appellants prevail on the nexus issue, refunds will be paid to Asworth, plus statutory interest through the date of the final and unappealable decision, and such that if the Appellee prevails on the nexus issue, the 1997 Refunds will be denied.

39. The parties further agree that the apportionment methodology approved by the Board or a Court in a final and unappealable decision in the matter herein will be applied to the 1997 Refund Claims (e.g., if single-factor apportionment is upheld, it will also apply to the 1997 Refund Claims, and if

three-factor apportionment is upheld, it will apply to the 1997 Refund Claims).

40. On January 16, 2001, Asworth timely filed amended returns refund claims with Revenue, contending that it did not have any tax liability in Kentucky, and sought refunds and statutory interest for all such tax paid for the taxable years ending December 31, 1998 and December 31, 1999 (the "1998-1999 Refund Claims").

41. On January 16, 2001, HTF timely filed amended returns/refund claims with Revenue, contending that it did not have any tax liability to Kentucky, and seeking refunds and statutory interest for all such tax paid for the taxable years ending January 31, 1997, December 31, 1997, December 31, 1998 and December 31, 1999 (the "HTF Refund Claims").

42. On January 16, 2001, D Aviation timely filed amended returns/refund claims with Revenue, contending that it did not have any tax liability to Kentucky, and seeking refunds and statutory interest for all such tax paid for the taxable years ending January 31, 1997, December 31, 1997, December 31, 1998 and December 31, 1999 (the "D Aviation Refund Claims").

43. Revenue subsequently denied the 1998-1999 Refund Claims, the HTF Refund Claims and the D Aviation Refund Claims, which led to a Protest, and then to this proceeding.

44. Revenue's refund denial letter of April 29, 2002 denied the 1998-1999 Refund Claims of $78,753, plus applicable statutory interest. The refund denial letter also denied the HTF Refund Claims in the aggregate amount of $1,952,820, plus applicable statutory interest. The refund denial letter further denied D Aviation's Refund Claims in the aggregate amount of $16,887, plus applicable statutory interest.

45. The Appellants timely protested the denials of the 1998-1999 Refund Claims, the HTF Refund Claims and the D Aviation Refund Claims.

46. After various administrative proceedings, Revenue issued final ruling letters on July 24, 2002 regarding the 1998-1999 Refund Claims, the HTF Refund Claims and the D Aviation Refund Claims.

47. The Appellants filed timely Petitions of Appeal with the Kentucky Board of Tax Appeals on August 15, 2002 in response to the July 24, 2002 Final Ruling letters.

48. On August 22, 2002, the Appellants filed a Motion to Consolidate all four appeals (KBTA File Nos. K00-R-31, K02-R-30, K02-R-31, K02-R-32), and on June 4, 2003, the Board granted the Motion.

49. On July 11, 2003, the Appellants filed a Petition for Writ of Mandamus contending that they were entitled to certain documents in discovery, which Revenue contended were privileged. The Appellants also contended that they were entitled to additional written and oral discovery as well. (*Asworth*

Corporation et al v. Revenue Cabinet, Franklin Circuit Court, Civil Action No. 03-CI-00856).

50. On March 16, 2004, the Franklin Circuit Court issued an Order denying the Appellants' Petition for Writ of Mandamus.

51. On March 26, 2004, the Appellants filed a Motion to Alter, Amend, or Vacate Judgment regarding the Court's March 16, 2004 Order.

52. On April 22, 2004, the Court issued an Order and Opinion denying the Appellants' Motion to Alter, Amend, or Vacate, and ordering that "the 766 pages of disputed discovery collected and withheld by the Revenue Cabinet be entered into the record yet remain sealed and confidential." (April 23, 2004 Slip Op. at 8.)

53. On May 20, 2004, Revenue filed in the record at the Board of Tax Appeals a Notice of Filing Under Seal with the disputed discovery documents attached, and filed a Notice of Filing Under Seal with the Franklin Circuit Court, also on May 20, 2004.

54. The parties agree that the documents in dispute in Civil Action No. 03-CI-00856 and filed under seal in the record in this matter will be transferred to any reviewing court in the event of an appeal by either party of a final Board decision in this matter.

55. Professor Richard D. Pomp is qualified as an expert due to his knowledge, skill, experience, training, and education pursuant to KRE 702.

56. On August 21, 2002, the Appellants took a CR 30.02(6) deposition of Revenue by deposing Paul Jones (appointed by Revenue as its representative), who was at that time a Tax Consultant with the Division of Tax Policy, a veteran of over 30 years of employment with Revenue.

57. During the deposition, the attending court reporter recording and transcribing the deposition inadvertently failed to record a portion of the testimony of Mr. Jones. Upon discovery of the court reporter's omission after reviewing said transcript, counsel for the Appellants immediately contacted her and requested the tape recording of the deposition for review. The court reporter advised the Appellants' counsel that she had "erased" the tapes immediately following her transcription of the deposition.

58. The parties agree that the omitted testimony of Mr. Jones was essentially as follows: if one of the entities identified in KRS 141.040(a) through (h) (for example S corporations, 26 USC § 501 exempt corporations, or exempt or religious institutions, educational institutions, etc . . .) also met the requirements set forth in KRS 141.206 (i.e., were corporations both resident and non-resident which were partners in a partnership doing business in Kentucky), Revenue would hold that no tax would be owed pursuant to or under KRS 141.206 because this category of corporate partners are entities specifically exempted from income tax pursuant to KRS 141.040(a) through (h).

Respectfully submitted,

Dated: September 7, 2005

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